

DEPARTMENT OF FINANCE BILL ANALYSIS

AMENDMENT DATE: July 15, 2009
POSITION: Neutral

BILL NUMBER: SB 401
AUTHOR: L. Wolk
RELATED BILLS: SB X3 17

BILL SUMMARY: Administration of Taxes: Tax Avoidance Transactions

This bill would eliminate inconsistencies in various abusive-tax-shelter (ATS) laws by providing a single, consistent definition for abusive tax shelters, which would be referred to as “potentially abusive tax avoidance transactions.” In addition, this bill would modify the definition of an abusive tax shelters use-penalty to no longer allow taxpayers to avoid the penalty by filing an amended return prior to the Franchise Tax Board (FTB) issuing a deficiency notice; instead, this bill would impose a 50-percent penalty in such situations.

FISCAL SUMMARY

The FTB estimates an accrued revenue gain of \$8.1 million in 2008-09 followed by a loss of \$1.7 million in 2009-10. Revenue gains of \$100,000 and \$8.5 million would be seen in 2010-11 and 2011-12 respectively. The FTB notes that the losses in 2009-10 attributed to delayed revenue related to the provision which would impose a 50-percent penalty if an amended return is filed. The delayed revenue associated with this provision would be collected in future years.

This bill would not significantly impact FTB costs.

COMMENTS

The Department of Finance is neutral on this bill.

- This bill would clarify state tax laws by providing a single, consistent definition for potential abusive tax avoidance transactions.
- This bill would improve the effectiveness of the abusive tax shelter penalty and improve related collections.
- This bill would change a “loophole” under current law which provides that no penalty is imposed if an amended return is filed prior to FTB issuing a deficiency notice, lessening the effectiveness of the penalty.
- This bill would result in a net accrued revenue gain in 2008-09 followed by a loss in 2009-10, and gains in 2010-11 and 2011-12.

Analyst/Principal (0723) C. Angaretis	Date	Program Budget Manager Mark Hill	Date
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Department Deputy Director	Date
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Governor's Office:	By:	Date:	Position Approved _____
			Position Disapproved _____

BILL ANALYSIS	Form DF-43 (Rev 03/95 Buff)
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L. Wolk

July 15, 2009

SB 401

ANALYSIS**A. Programmatic Analysis**

This bill would be effective January 1, 2010. The provision relating to the eight-year statute of limitations would be operative for taxable years beginning on or after January 1, 2009.

Under current federal law, a "tax shelter" is generally a partnership or other entity (such as a corporation or trust), an investment plan or arrangement, or any other plan or arrangement used for the principal purpose of avoiding or evading tax. These transactions generally have no business purpose other than reducing tax; however, a tax shelter is often cloaked in a series of transactions to make it appear to have a business purpose or structured to create an incidental business purpose.

A reportable transaction is generally any transaction that has a potential for avoiding or evading tax and the transaction is required to be included a return or statement. Federal law requires a taxpayer who participated in a reportable transaction to disclose the transaction on an original or amended return for any taxable year the taxpayer participates in the transaction.

A listed transaction is a transaction that has been identified by the IRS of the FTB to be a tax-avoidance transaction.

The Internal Revenue Code (IRC) requires the payment of interest on any amount of tax imposed that is not paid on or before the last date prescribed for payment of tax. The IRC precludes taxpayers from filing administrative claims for abatement with respect to income, estate or gift taxes. However, the IRC provides an exception to the general rule under the interest-suspension rule. The interest-suspension rule suspends the accrual of interest and time-sensitive penalties if the Secretary of the Treasury does not provide notice to the taxpayer specifically stating the amount due and the basis for the liability within 36 months of the later of the due date of the return (without regard to extensions) or the date the return is filed. The interest-suspension rule does not apply to any interest, penalty, and addition to tax, or additional amount with respect to any undisclosed reportable transaction, listed transaction, or gross misstatement.

Current state law uses the following definitions and provisions to curtail the use of abusive tax shelters:

- **Potentially Abusive Tax Avoidance Transaction:** Defined as any tax shelter or a plan or arrangement which is of a type that the Secretary of the Treasury or the FTB determines by regulation as having a potential for tax avoidance or evasion.
- **Eight-Year Statute:** If the FTB identifies an adjustment relating to an "abusive tax avoidance transaction," the FTB may notify the taxpayer of a proposed deficiency assessment up to eight years after the taxpayer has filed the return, rather than the normal four-year statute of limitations.
- **Abusive-Tax-Shelter-Use Penalty:** Applies if the FTB contacts a taxpayer regarding a deficiency that results from the use of an undisclosed reportable transaction, a listed transaction, or a gross misstatement. The penalty is 100 percent of the interest payable up to the date that a notice of proposed deficiency is mailed. Current law provides that no penalty be imposed if an amended return is filed prior to the FTB issuing a deficiency notice.

L. Wolk

July 15, 2009

SB 401

- Interest Suspension: The imposition of penalties and interest may be subject to temporary suspension if FTB does not issue a notice within 18 months from the date of a timely-filed return. Interest may not be computed on the additional proposed tax from the day after that 18-month period until 15 days after the notice is issued. This rule does not apply to taxpayers with income greater than \$200,000 and that have been contacted by FTB regarding a "potentially abusive tax shelter." This provision refers to abusive-tax-shelter-use penalty rules for the definition of a "potentially abusive tax shelter."
- Noneconomic Substance Transaction Understatement (NEST) Penalty: California imposes a penalty for any understatement attributable to any transaction that lacks economic substance. A "noneconomic substance transaction understatement" is a reportable transaction understatement, or an understatement resulting from the disallowance of any loss, deduction or credit or addition to income that is attributable to a determination that the arrangement lacks economic substance. A transaction is treated as lacking economic substance if the taxpayer does not have a valid nontax business purpose for entering into the transaction. Current law imposes a penalty of 40 percent of the understatement if the transaction is not disclosed, and 20 percent for disclosed transactions.

This bill provides a single definition for abusive tax shelters, which would be referred to as "potentially abusive tax avoidance transactions." The single definition would mean any of the following:

- A federal tax shelter;
- An undisclosed reportable transaction;
- A listed transaction;
- A gross misstatement; or
- A transaction subject to the noneconomic substance transaction understatement penalty.

This bill coordinates the definition of "potentially abusive tax shelters" in the application of:

- The eight-year statute of limitations,
- The abusive-tax-shelter-use penalty,
- The interest-suspension rule, and
- The authority to issue subpoenas.

This bill would modify the abusive-tax-shelter-use penalty by imposing a 50-percent penalty when an amended return is filed before a deficiency notice is issued. Thus, taxpayers would no longer be allowed to avoid the penalty by filing an amended return prior to the issuance of a notice of proposed deficiency. Additionally, the Chief Counsel of the FTB would be allowed to compromise all or any portion of the penalty.

This bill would adopt the federal reportable transaction category for "transactions of interest", and provides similar authority to the FTB to determine transactions of interest for California income or franchise tax purposes.

DISCUSSION:

Conference language in SB X3 17 included a provision similar to the language of this bill. SB X3 17 was vetoed by the Governor on June 30, 2009, but not specifically because of this provision. His veto message stated "I am returning Senate Bill X3 17 without my signature. I have been very clear that the Legislature must solve the entire deficit, must make the hard decisions now, and must not push the problem off to tomorrow. This bill and its companion measure, SB X3 16, do not meet any of those criteria."

BILL ANALYSIS/ENROLLED BILL REPORT--(CONTINUED)**Form DF-43****AUTHOR****AMENDMENT DATE****BILL NUMBER**

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SB 401

B. Fiscal Analysis

The FTB estimates an accrued revenue gain of \$8.1 million in 2008-09 followed by a loss of \$1.7 million in 2009-10. Revenue gains of \$100,000 and \$8.5 million would be seen in 2010-11 and 2011-12 respectively. The FTB notes that the losses in 2009-10 attributed to delayed revenue related to the provision which would impose a 50-percent penalty if an amended return is filed. The delayed revenue associated with this provision would be collected in future years.

This bill would not significantly impact FTB costs.

Code/Department Agency or Revenue Type	SO	(Fiscal Impact by Fiscal Year)							
	LA	(Dollars in Thousands)							
	CO	PROP							Fund
	RV	98	FC	2009-2010	FC	2010-2011	FC	2011-2012	Code
1147/Pers Inc Tax	RV	Yes	U	-\$1,700	U	\$100	U	\$8,500	0001
1730/FTB	SO	No		----- No/Minor Fiscal Impact -----					0001